THE ROAD FROM "TWIN PEAKS" – AND THE WAY BACK

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This article explores the fragmented regulatory structure of financial markets in the United States in light of the current financial crisis. Two approaches for regulatory reform that originated in the United Kingdom are presented. The first approach is the creation of a unified regulatory agency responsible for regulating all the main segments of the financial services industry. The second, also known as the "Twin Peaks" approach, is to structure regulation around two agencies, one responsible for the safety and soundness of all financial firms and the other for regulating their sales practices. This article describes the debate in the UK prior to the creation of one unified regulatory agency, the Financial Services Authority (FSA). Next, it explores justifications for a single regulator, such as the FSA, followed by a discussion of the rejection of the "Twin Peaks" approach in the UK. Subsequently, the debate regarding the role of a central bank, like the Bank of England in the UK, is discussed. Then US regulatory reform is reviewed in terms of the lessons of the British experience of creating a single regulatory agency. Finally, the concluding section describes how some variation of the "Twin Peaks" alternative would prove to be more successful than the single regulator approach.

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I. INTRODUCTION

The Global Financial Crisis has put the spotlight on the United States' complex and fragmented regulatory structure as an issue of global systemic importance. The failure of large investment banks like Bear Stearns and Lehman Brothers has put into question the adequacy of the regulation of large non-bank financial intermediaries. The lack of consolidated supervision of the AIG group, with its Financial Products

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Division falling under the authority of the Office of Thrift Supervision (OTS) while the insurance company was regulated at State level, further illustrates the systemic problems created by regulatory fragmentation. Finally, the Commodities Futures Modernization Act, which deliberately excluded the regulatory authority of both the SEC and the CFTC from the Credit Default Swaps market, resulted in a failure to ensure adequate regulation of that market with implications for the global financial system.

In a message clearly directed to US policy-makers, the Group of Thirty, a think tank comprising some of the most distinguished figures from international finance, has recommended in its report on *Financial Reform: A Framework for Financial Stability*: "Countries should reevaluate their regulatory structures with a view to eliminating unnecessary overlaps and gaps in coverage and complexity, removing the potential for regulatory arbitrage, and improving regulatory coordination."[1] This reevaluation has now begun, with the structure of US regulation being seriously re-examined for the first time in over a generation. Although the 1999 Gramm-Leach-Bliley Act dismantled the structural barriers between commercial and investment banking and between banking and insurance, it did not result in significant structural change to the complex and over-lapping authorities of US regulatory agencies.[2] However, in March 2008, the Bush administration unveiled a plan for a major structural reform of regulation,[3] while more recently the Obama administration has proposed a similar, but less radical reform, to Congress.[4]

The U.S. debate on regulatory structure has lagged behind in other countries of the Organisation for Economic Cooperation and Development (OECD) by over a decade.[5] By the end of the last century many of these

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1 GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 10 (2009), *available at* http://www.group30.org/pubs/recommendations.pdf.

2 Heidi Mandanis Schooner & Michael Taylor, *United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets*, 38 TEX. INT'L L.J. 317, 327-29 (2003).

3 U.S. DEP'T OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf.

4 U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009) *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

5 Schooner & Taylor, *supra* note 2, at 320. For a discussion of reform elsewhere in the OECD, *see id.* at 340-44.

countries had already embarked on major reorganizations of their institutional structures of financial regulation.[6] These reform initiatives were presented as a response to the challenge of regulating today's increasingly integrated financial markets in which the traditional distinctions between banking, securities, and insurance had become blurred.[7] Moreover, with the dismantling of the structural regulations that had previously segmented the financial industry, diversified financial conglomerates had emerged, necessitating a group-wide perspective to ensure their effective regulation.[8]

Two broad approaches emerged in response to these challenges.[9] The first, and most high profile, was the approach adopted in the United Kingdom that created a unified regulatory agency responsible for regulating all three of the main segments of the financial services industry for both financial soundness and consumer protection purposes.[10] The alternative approach, which had originated in the U.K. but was not adopted there, was to structure regulation around two agencies, one responsible for the safety and soundness of all financial firms and the other for regulating their sales practices.[11] This "Twin Peaks" approach was adopted first in Australia and later in the Netherlands.[12] Variations of it are also to be found in Spain, France and Canada.

This essay attempts to distil some lessons for the United States from the U.K.'s reforms and especially the factors that led to the creation of a single, unified regulatory agency, the Financial Services Authority

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6 *Id.* at 340-44.

7 *Id.* at 340.

8 *Id.* at 323.

9 *See* Richard K. Abrams & Michael W. Taylor, *Issues in the Unification of Financial Sector Supervision* 22-23 (Int'l Monetary Fund, Working Paper No. 00/213, 2000), *available at* http://www.imf.org/external/pubs/ft/wp/2000/wp00213.pdf. Within these two broad forms there is also scope for substantial variation. *See id.* at 21-24.

10 For a general review of the background to the U.K.'s reforms, *see* Eilìs Ferran, *Examining the United Kingdom's Experience in Adopting the Single Regulator Model*, 28 BROOK. J. INT'L L. 257 (2003).

11 MICHAEL TAYLOR, "TWIN PEAKS": A REGULATORY STRUCTURE FOR THE NEW CENTURY 10-11 (Ctr. for the Study of Financial Innovation) (1995).

12 SELECT COMMITTEE ON ECONOMIC AFFAIRS, BANKING SUPERVISION AND REGULATION, 2008-9, H.L. 101-I, at 34.

(FSA).[13] The radicalism of the U.K.'s approach should not be underestimated. Not only did it involve the merger of nine pre-existing regulatory agencies[14] into one but, most controversially, it involved the decision to remove the responsibility for bank regulation from the Bank of England, the U.K.'s central bank, and to transfer it to the FSA.[15] Although unified regulators had been previously created elsewhere, most notably in Scandinavia, none had involved the removal of bank regulation authority from the central bank.[16]

Critics of the U.K.'s arrangements at the time of the FSA's creation charged that the separation of bank regulation from the central bank's lender of last resort (LoLR) responsibilities was highly risky. It was argued that without the detailed institutional knowledge that derives from bank regulatory authority, the Bank of England would be unable to perform its LoLR responsibilities adequately. The subsequent experience of the run on the British mortgage bank Northern Rock in September 2007 seemed to confirm these critics. However, as this essay will argue, this conclusion overlooks the range of possible alternatives to the U.K.'s reforms, and particularly the Twin Peaks model. A "Twin Peaks" separation of prudential (safety and soundness) and consumer protection regulation would have offered a number of advantages over the FSA, including in relation to crisis management arrangements. The essay concludes by

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[13] For an assessment of the FSA more generally, see Howell E. Jackson, *An American Perspective on the U.K. Financial Services Authority: Politics, Goals & Regulatory Intensity* (Harvard, John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 522, 2005), *available at* http://www.law.harvard.edu/ programs/olin_center/papers/pdf/ Jackson_522.pdf.

[14] Clive Briault, *The Rationale for a Single National Financial Services Regulator* 6 (Fin. Servs. Auth., Occasional Paper No. 2, 1999), *available at* http://www.fsa.gov.uk/pubs/ occpapers/OP02.pdf. These agencies include the Securities and Investments Board, the Personal Investment Authority, the Investment Management Regulatory Organisation, the Securities and Futures Authority, the Supervision and Surveillance Division of the Bank of England, the Building Societies Commission, the Insurance Directorate of the Department of Trade and Industry, the Friendly Societies Commission, and the Registrar of Friendly Societies. *Id.* at 6 n.1.

[15] *Id.* at 7.

[16] *See* Michael Taylor & Alex Fleming, *Integrated Financial Supervision: Lessons from Northern European Experience* 17 (World Bank, Working Paper 2223, 1999), *available at* http://info.worldbank.org/etools/docs/library/ 50180/TaylorFleming_1999.pdf.

drawing some conclusions from the British experience that might be considered by policy-makers in the U.S.[17]

II. THE DEBATE IN THE UK PRIOR TO THE FSA

What is striking about the policy debate within the U.K. prior to the formation of what became the FSA, is just how little attention was given to the possibility of creating a single integrated financial regulator. For several years prior to the election of a new Labour government in May 1997, there had been discussion of the need to reform the U.K.'s regulatory system, but the ideas being debated stopped short of proposing to create a single regulatory agency with a mandate that covered the entire banking, insurance and investment industries.[18] The concept only came to prominence on May 20, 1997 with an announcement to the House of Commons by the new Chancellor of the Exchequer that the government intended to create a single regulatory authority for the banking and securities industries. The announcement itself came as a surprise to many observers and showed signs of having been rapidly prepared. This impression arose not only because the statement was vague concerning matters of detail, but also because it did not address some more fundamental issues, such as whether the prudential regulation of insurance companies would be included in the scope of the new regulator.[19]

Prior to this announcement, the British regulatory system combined institutional and functional regulation, similar to the system created by the

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[17] For further discussion regarding the Twin Peaks model in a U.S. context, see Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441 (1998); Howell E. Jackson, *A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States*, (Harvard Law Sch., Working Paper No. 09-19, 2008), *available at* http://ssrn.com/abstract=1300431; Cynthia Crawford Lichtenstein, *The Fed's New Model of Supervision for "Large Complex Banking Organizations": Coordinated Risk-Based Supervision of Financial Multinationals for International Financial Stability* (Boston College Law Sch. Research Paper No. 89, 2006), *available at* http://ssrn.com/abstract=882474.

[18] Schooner & Taylor, *supra* note 2, at 320.

[19] Ensuring the solvency of insurance companies had been the responsibility of the Department of Trade and Industry although it was briefly transferred to HM Treasury before the FSA was established. In July 1997, i.e. two months after the original announcement, the government confirmed that this function would also form part of the responsibilities of the new agency.

Gramm-Leach-Bliley Act in the United States.[20] Banks were regulated by the Bank of England under the Banking Act 1987[21] with respect to their safety and soundness, while insurance companies were subject to solvency regulation under the Insurance Companies Act of 1982[22] by a department of the Treasury (a function which was previously discharged by the Department of Trade and Industry). Sales practice ("conduct of business") regulation was in the hands of a network of self-regulating organisations (SROs) which were also responsible for the safety and soundness regulation of non-bank financial intermediaries such as securities brokers and dealers and investment managers.

The SRO system was established by the Financial Services Act 1986[23] which had been described as "self-regulation within a statutory framework" both by its chief architect[24] and the Conservative government that enacted it. This system had been designed to provide an all-encompassing investor protection regime for securities, mutual funds, and other forms of collective investment through a number of "Self-Regulating Organizations" overseen by a quasi-governmental body, the Securities and Investments Board (SIB).[25] The SROs administered the sales practice regime and were responsible for ensuring that the users of financial services (generally speaking, securities brokering and dealing; futures brokering and dealing; investment management; financial advice; and sales practices relating to collective investment schemes like personal pensions and life insurance) were subject to appropriate levels of consumer protection. This system applied a functional approach to the regulation of investment services, products, and advice. If a service or product was being offered, it needed to be regulated by the relevant SRO, no matter what the nature of the firm offering the service.

The Financial Services Act was initially administered by no fewer than five separate SROs: The Securities Association (TSA) for Stock

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[20] Schooner & Taylor, *supra* note 2, at 324-25.

[21] Banking Act, 1987, c. 22, § 1 (Eng.) (repealed 2001).

[22] Insurance Companies Act, 1982, c. 50, § 3 (Eng.) (repealed 2001).

[23] Financial Services Act, 1986, c. 60, § 8 (Eng.) (repealed 2001).

[24] L.C.B. Gower, *"Big Bang" and City Regulation*, 51 MOD. L. REV. 1, 11 (1988).

[25] The SIB exercised powers that were transferred to it under the Financial Services Act by the Secretary of State for Trade and Industry (a government minister). However, the SIB itself was in the unusual position of being a company limited by guarantee and not a department of government. A similar structure was subsequently adopted for the Financial Services Authority.

Exchange brokers and dealers; the Association of Futures Brokers and Dealers (AFBD) for dealers in futures and options; the Investment Management Regulatory Organisation (IMRO) for asset management and mutual funds; the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO) for collective investment schemes marketed by insurance companies; and the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA) for independent financial advisers, many of whom acted as agents of the insurance companies.[26] During the later years of the self-regulatory system's existence some streamlining took place: the TSA and AFBD merged, as did LAUTRO and FIMBRA, thus reducing the number of SROs to three. Nonetheless the system was criticized for its complexity and opacity to the consumer, especially as it gave rise to what was described as an " 'alphabet soup' of regulatory agencies."[27] At the same time, the financial services industry criticised the system for not being genuinely self-regulatory, and for imposing an inappropriate regulatory burden on the interprofessional ("wholesale") money and capital markets. The SIB developed its own rulebook and required the SROs to adopt "equivalent" standards. This resulted in a lesser role for practitioner input and greater uniformity in the SRO rulebooks than had originally been intended.[28]

However, the SRO system was most thoroughly discredited in the eyes of opposition lawmakers by what became known as the "pensions mis-selling scandal."[29] It had been the policy of the Conservative government in the mid-1980s to encourage more personal provision for retirement, rather than relying on occupational or state-provided schemes. Approximately eight million personal pensions were sold in the UK between 1988 and 1995.[30] The SRO system was intended in part to provide protection for individuals who entered into one of these personal savings schemes; in the words of John Major (then a junior minister but later

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[26] See the account given by DAVID F. LOMAX, LONDON MARKETS AFTER THE FINANCIAL SERVICES ACT 78 (1987).

[27] Taylor, *supra* note 11, at 7.

[28] These criticisms were recognized in a report issued by Andrew Large when he assumed the Chairmanship of the SIB in 1993. ANDREW LARGE, FINANCIAL SERVICES REGULATION: MAKING THE TWO TIER SYSTEM WORK (London: Securities and Investments Board, 1993).

[29] PETER CARTWRIGHT, CONSUMER PROTECTION IN FINANCIAL SERVICES 152 (1999).

[30] Michael Taylor, *The Policy Background in* BLACKSTONE'S GUIDE TO THE FINANCIAL SERVICES. & MARKETS ACT OF 2000 14 (Michael Blair ed., 2000).

Prime Minister) the Financial Services Act would "safeguard people against the unscrupulous overselling of personal pensions."[31]

Personal pension plans were mainly offered by insurance companies (regulated by LAUTRO) which employed a sales staff with a large commission element in their remuneration. By 1993 it had emerged that a significant number of public sector employees, including teachers, nurses and the employees of former state-owned industries such as coal mining, had been encouraged by these salespeople to switch from their occupational schemes to personal pension plans. As the employer-provided plans were defined benefit, whereas the personal plans were defined contribution, this arguably placed these individuals at a potentially serious financial disadvantage.[32] A report commissioned by the SIB suggested that as many as 1.5 million pensions had been mis-sold with compensation costs amounting to some £4 billion. Many of those affected were a core constituency of the Labour party – public sector workers – and hence the issue became highly politicised with the opposition party using it as a stick with which to beat the government.[33]

Before winning the 1997 General Election Labour, party spokesmen had committed the party to end what they termed "City self-regulation."[34] One of the few definite policy commitments to emerge from their pledge was the intention, once in government, to abolish the two-tier system of SIB and SROs.[35] In its place they undertook to establish a single, statutory regulatory agency for securities and investments. Thus the commitment to end City self-regulation might be narrowly construed as the commitment to replace the system created by the Financial Services Act.

At the same time, however, there were indications that the Labour party also considered the Bank of England to be part of the City's "self-regulatory" system, even though its powers to regulate banks derived from

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[31] Michael Taylor, *Fin. Svcs..& Mkts. Act: The Policy Background-II*, 31 AMICUS CURIAE 4, 6 (2000).

[32] Whether the individuals were disadvantaged and to what extent depended on a number of actuarial assumptions and assumptions about investment returns. The intricacies of these issues were, however, drowned out in the subsequent political debate.

[33] *See, e.g.,* 318, PARL. DEB., H.C. (6th ser.) (1998) 716, 718. (It continued to be used by Labour ministers against their Conservative opposite numbers even after the change of government).

[34] Mike O'Brien, *Labour's Proposals for Regulation into the 21st Century*, 5 J. FIN. REG. & COMPLIANCE 115, 115-17 (1997).

[35] LABOUR PARTY, LABOUR'S BUSINESS MANIFESTO (1997).

a separate statute (the Banking Act 1987) and even though, unlike the SROs, it was a government agency. Labour suspicion of Britain's central bank ran deep, with some commentators suggesting that it can be traced to the Bank's role in the sterling crisis of 1931 that had helped to bring down a minority Labour administration headed by Ramsay Macdonald.[36] This fuelled Labour suspicions that the Bank of England was too closely aligned with the Conservative party, in which the financial interests of the City of London had a major influence. Thus when the British government considered the introduction of statute-based bank regulation in the mid-1970s some members of the governing Labour party proposed establishing a banking commission independent of the Bank of England to exercise regulatory powers. These proposals were rejected by the Cabinet after the then Governor of the Bank of England fought a rearguard action to ensure that it became the bank regulator.[37] Nonetheless, in subsequent years the Bank was to show itself a reluctant regulator which above all wished to maintain its traditional, informal relationship with the leading financial institutions in the City. Against this background it was possible to present it as part of the City's "self-regulating" system and as merely the chief spokesman for a "cosy club."

Nonetheless, it is doubtful whether the Bank of England's responsibility for regulating the banking sector would have come under renewed scrutiny had it not been for two incidents in the first half of the 1990s. The first was the failure of the Bank of Credit and Commerce International (BCCI), which went into insolvent liquidation once it became clear that it had been a vehicle for a massive fraud.[38] Although the bank only had branches in the U.K. (its holding company was registered in Luxembourg), the group's "mind and management" had been in London and hence there was a case for the Bank of England having taken the lead in ensuring that the group as a whole was subject to consolidated supervision. In a subsequent investigation conducted by Sir Thomas (later Lord Justice) Bingham, a senior judge, the Bank was found to have adopted

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[36] MICHAEL MORAN, THE POLITICS OF BANKING: THE STRANGE CASE OF COMPETITION & CREDIT CONTROL 120 (2d ed., 1986).

[37] *Id.*

[38] H.M. STATIONARY OFFICE, INQUIRY INTO THE SUPERVISION OF THE BANK OF CREDIT & COMMERCE INT'L. (1992).

an excessively narrow interpretation of its powers and, partly for that reason, it had not been sufficiently proactive in regulating BCCI.[39]

In BCCI's case, the Bank of England could argue in its defence that it was a bank regulator not a fraud investigator. No such defence was available in relation to the second episode – the failure of Barings merchant bank in early 1995.[40] Barings had been part of the City of London's "aristocracy," a centuries old merchant bank that had for generations been at the heart of the City's establishment to the extent of providing several Governors of the Bank of England. Barings had failed once before, in 1890, as the result of speculation in railroad construction in South America.[41] It had been then bailed out by the Bank of England, at that time still a privately owned corporation.[42] One hundred and five years later, Barings failed again, this time due to the poorly controlled activities of a futures trader based in Singapore who took large unhedged positions in the Singapore and Osaka futures exchanges.[43] This was the first of several episodes involving what came to be called "rogue traders" in the years that followed.[44] The episode was damaging to the Bank of England since it appeared that Barings had enjoyed a relatively light touch regulatory regime and thus provided an illustration of the operation of a so-called "self-regulatory system," at least as far as it applied to members of the City's establishment.[45]

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[39] 212 PARL. DEB., H.C. (6th ser.) (1992) 575. According to a statement given to the House of Commons by the then Chancellor of the Exchequer Norman Lamont, the Bingham report "argues that the Bank was slow to impose on BCCI an appropriate supervisory regime, and concludes that the Bank continued for too long to rely on the Luxembourg authorities to play the leading role." *Id.*

[40] H.M. STATIONARY OFFICE, REPORT OF THE BOARD OF BANKING SUPERVISION INQUIRY INTO THE CIRCUMSTANCES OF THE COLLAPSE OF BARINGS (1995).

[41] *See* JOHN GAPPER & NICHOLAS DENTON, ALL THAT GLITTERS: THE FALL OF BARINGS 2 (1996).

[42] *Id.*

[43] *Id.* at 28-29.

[44] A phrase that was originally coined to describe the Barings trader, Nick Leeson, which he used as the title of his subsequent book: NICK LEESON & EDWARD WHITLEY, ROGUE TRADER: HOW I BROUGHT DOWN BARINGS BANK AND SHOOK THE FINANCIAL WORLD (1996).

[45] *See* Gordon Brown, Ch. of the Exch., Statement to the H.C. on the Bank of Eng. (May 20, 1997), ("SIB will become the single regulator underpinned by statute. The current system of self-regulation will be replaced by a new and fully statutory system, which will put the public interest first, and increase public

Despite these episodes, Labour entered office in 1997 without a clear commitment to removing the Bank of England's responsibility for bank regulation. Nor was there any indication of the possibility that a single financial regulator was on the policy agenda. What changed this situation was the new government's announcement in its first few days in office that it would grant the Bank of England independence to set interest rates. Although this policy was not featured in the Labour party's manifesto, central bank independence had been debated extensively in Britain since the early part of the decade.[46] On occasion in this debate the question of the central bank's regulatory powers had arisen without, however, any definitive conclusion being reached. Nonetheless, once the decision was taken to create an independent central bank, a new Bank of England Act was required and this seems to have provided the pretext for a re-examination of the Bank's role as bank supervisor.[47]

The decision to remove banking supervision from the Bank of England appears to have been taken opportunistically. Before the start of each parliamentary year in Britain, each government department must put in "bids" for parliamentary time for the passage of legislation that it considers essential. The successful bids are then included in the government's annual legislative program announced to parliament in the "Queen's Speech." In 1997 Treasury ministers wished to introduce two major bills – one to grant the Bank of England its independence, the other to abolish the "two tier" system of SIB and SROs created by the Financial Services Act. However, the new government had an ambitious policy agenda and a crowded legislative timetable, resulting in the Treasury being granted the time for only one major bill. According to the director of the Association of British Insurers, speaking the year after the event:

> The Treasury team had failed to secure in the first Queen's Speech legislation to abolish the two tier system under the Financial Services Act and Markets Act. However, a separate decision had been taken to give the Bank of England independence in respect of conducting monetary

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confidence in the system." (From the context it appeared that he considered the Bank of England to be part of the self-regulatory system). *Id.*

[46] *See* Michael Taylor, *Central Bank Independence.: The Policy Background*, *in* BLACKSTONE'S GUIDE TO THE FINANCIAL SERVICES AND MARKETS ACT OF 2000 at 10 (Michael Blair ed., 1998).

[47] *See* Ferran, *supra* note 10, at 271-72.

> policy and this did require legislation. It seems that an opportunist decision was taken at this stage to move towards a single regulator because the legislation to give the Bank of England independence in respect of monetary policy could be used for any other purpose relevant to the Bank of England.[48]

One of these "other purposes" was the transfer of responsibility for bank regulation from the Bank of England to the SIB, which then became the nucleus of the FSA. In other words, the parliamentary timetable rather than a reasoned policy debate seems to have triggered the decision to move to a single regulator. This also would have been consistent with an apparent about-turn in government policy after the Governor of the Bank of England apparently had been assured there were no immediate plans to strip the Bank of its bank regulatory function.

There have also been allegations that the concept of a single financial regulator had been developed within the Treasury before the change of government and had been inspired as much by Treasury rivalry with the Bank as by any policy considerations.[49] It was certainly the case that government ministers saw a single financial services regulator as an alternative centre of power to the Bank and hoped that the FSA would assume the Bank's role as overseer of the City's interests. Since the government was committed to establishing Bank of England independence in respect of monetary policy, it is also possible that removing its banking supervision function was seen as a way of preventing it from becoming "an over-mighty subject." Whatever the exact motivation, it is clear that the momentous implications of an opportunistic and essentially political decision may not have been fully appreciated by government ministers who were still new to power after their party's unusually long period out of office.[50]

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[48] *See* Ferran, *supra* note 10, at 271.

[49] *See* SIR MARTIN JACOMB, RE-EMPOWER THE BANK OF ENG. 2-4 (Centre for Policy Stud.) (2009) *available at* http://www.cps.org.uk/cps_catalog/Re-empower%20the %20Bank%20of%20England.pdf.

[50] It is important in this regard that the Labour party had been out of power for 18 years and few of its lawmakers had experience of government.

III. JUSTIFYING THE SINGLE REGULATOR

The decision to create a single financial regulator had to be justified after the fact. Government ministers and the FSA itself put forward a series of justifications for the creation of a single regulator. They fell into two broad categories: those relating to market developments and those relating to the purported effectiveness and efficiency of a single regulatory agency.

The argument that market developments justified a single financial regulator became known as the "blurring the boundaries" argument. In his statement to the House of Commons on May 20, 1997, Britain's Chancellor of the Exchequer argued that:

> At the same time, it is clear that the distinctions between different types of financial institution--banks, securities firms and insurance companies--are becoming increasingly blurred. Many of today's financial institutions are regulated by a plethora of different supervisors. This increases the cost and reduces the effectiveness of the supervision.
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> There is therefore a strong case in principle for bringing the regulation of banking, securities and insurance together under one roof. Firms now organise and manage their businesses on a group-wide basis. Regulators need to look at them in a consistent way. That would bring the regulatory structure closer into line with today's increasingly integrated financial markets. It would deliver more effective and efficient supervision, giving both firms and customers better value for money, and would improve the competitiveness of the sector and create a regulatory regime to genuinely meet the challenges of the 21st century.[51]

The argument was further developed in a document issued by the Treasury the following year:

> The existing arrangements for financial regulation involve a large number of regulators, each responsible for different

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[51] 294 PARL. DEB., H.C. (6th ser.) (1997) 510.

> parts of the industry. In recent years there has been a blurring of the distinctions between different kinds of financial services business: banks, building societies, investment firms, insurance companies and others. This has added further to the complexity of financial regulation. The Government believes the current system is costly, inefficient and confusing for both regulated firms and their customers. It is not delivering a standard of supervision and investor protection that the public has a right to expect. We are therefore establishing a single, statutory regulator for the UK financial services industry with clearly defined regulatory objectives and a single set of coherent functions and powers.[52]

However, it was left to the FSA itself to provide the most extensive justification for its own existence. While the FSA was still under construction, it published a paper written by one of its own officials, Clive Briault, who set out to defend the single regulator concept.[53] He did so by first invoking the "blurring of boundaries" argument:

> The securitisation of traditional forms of credit (including mortgages, credit card outstandings and commercial loans) and, with the growth of options, increasingly elaborate ways of unbundling, repackaging and trading risks, have weakened the distinction between equity, debt and loans, and even between banking and insurance business (where, for example, credit derivatives bear many of the characteristics of an insurance product and insurance companies offer short-term deposit-like products).[54]

This development, Briault explained, had an important consumer protection dimension in that the disappearance of a neat conjunction between a particular type of firm and a limited range of products being supplied by that firm means that it is difficult to regulate on a functional basis, since the

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[52] H.M. STATIONARY OFFICE, FIN. SVCS. & MKTS. BILL: A CONSULTATION DOCUMENT, pt. 1 (1998).

[53] *See* Briault, *supra* note 14.

[54] *Id.* at 13-14.

traditional functional approach no longer matches the structure of either firms or markets.[55]

Accordingly, a single financial regulator was essential to provide adequate consumer protection when financial products could no longer be neatly slotted into the traditional contractual forms which have underpinned the functional approach to regulation.[56] Trying to regulate the sale and marketing of products on a functional basis would result in inadequate consumer protection, either because similar products would become subject to different levels of consumer protection or the regulatory agencies disputed jurisdiction over certain types of product.[57]

The blurring the boundaries argument also related to the formation of financial conglomerate groups. The emergence of financial conglomerates (usually defined as a group which undertakes at least two of the activities of banking, securities or insurance) resulted from mergers and acquisitions that occurred most frequently between banks and securities firms and between banks and insurance companies.[58] In some cases they also involved the purchase of fund managers by banks and by insurance companies.[59] These combinations were permitted as the result of the dismantling of structural barriers – which in the U.K. had been mainly informal and non-statute based – in the course of the 1980s.[60] In response to these and similar developments elsewhere in the G10, the Tripartite Group of banking, securities, and insurance supervisors argued in a 1995 report that a "group-wide" perspective was required to obtain an adequate supervisory overview of these financial conglomerates.[61] Nonetheless, as long as regulation remained structured along traditional institutional/functional lines, obtaining such a group-wide perspective would be difficult.

The British solution was to adopt the lead regulator concept.[62] The lead regulator would be responsible for taking a consolidated view of the

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55 *Id.* at 14.
56 *See id.*
57 *See id.*
58 *Id.* at 12-13.
59 Briault, *supra*, note 14, at 13.
60 TRIPARTITE GROUP OF BANK SEC. & INS. REG., THE SUPERVISION OF FIN. CONGLOMERATES at i (1995). Subsequently the Tripartite Group was renamed the Joint Forum.
61 *Id.* at i-ii.
62 *See* GEORGE ALEXANDER WALKER, INT'L BANKING REGULATION: LAW, POLICY AND PRACTICE 258 (Kluwer Law Int'l) (2001).

capital adequacy and liquidity of the consolidated group; taking a similarly group-wide view of more qualitative factors such as the calibre of senior management and the high-level systems and controls of the financial conglomerate; and co-ordinating and encouraging the exchange of information among the relevant regulatory bodies, both routinely and in the event of an emergency. Typically, since most such groups were headed by a bank, the Bank of England usually assumed this responsibility ,which was similar to the Fed's umbrella supervisor role created by Gramm-Leach-Bliley.[63] In contrast to the U.S. arrangements, however, the Bank of England's role was largely extra-statutory and was the result of a framework of Memorandums of Understanding (MoUs) between the Bank of England and the functional regulators.

Although Briault claimed that the lead regulator concept had worked well, he nonetheless stressed that countries that had moved towards a single regulator had "done so in part because, with the growth in the number of multiple-function firms, the need for communication, co-ordination, co-operation and consistency across specialist regulatory bodies had become increasingly acute and increasingly difficult to manage efficiently."[64] If such firms were the rule rather than the exception (in contrast to the situation in the past) then new institutional arrangements were required to ensure that that they were subject to more efficient oversight. Briault cited statistics to show that many firms were now subject to multiple regulators: eight firms (including HSBC, Halifax, Abbey National and the Royal Bank of Scotland) were authorised to conduct all five of the main regulated activities ("deposit-taking, insurance, securities and corporate finance, fund management, and advising on or selling investment products to retail customers").[65] A further 13 firms were authorised to conduct four of these activities, and more than 50 other firms were authorised for three of these five functions.[66]

The efficient supervision of financial conglomerates was only one dimension of the superior efficiency claimed for the single regulator. It was also argued that it would allow scarce supervisory resources to be deployed more effectively; an example concerned the development of specialist teams to review firms' internal risk management models that had become an integral part of regulation during the 1990s. In the pre-FSA

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63 Schooner & Taylor, *supra* note 2.
64 Briault, *supra* note 14, at 15.
65 Briault, *supra* note 14, at 13.
66 *Id.*

system, several different regulators had needed to build their own specialist model review teams, but individuals with the requisite skills were in high demand which made it difficult for regulatory agencies to recruit them in sufficient numbers.[67] By centralizing the available resources, a single regulator seemed to offer a way out of this impasse. Similarly, it was also argued that the creation of a single support infrastructure (e.g. IT system) would lead to significant cost savings as the duplication and overlap resulting from the nine pre-existing regulators was eliminated. The argument that a single regulator would be more cost effective was vital in selling the concept to the financial industry. It was therefore not surprising that Briault made much of this argument:

> Economies of scale and scope should arise because a single regulator can take advantage of a single set of central support services (human resources, information services, financial control, premises etc); introduce a unified statistical reporting system for regulated firms; operate a single database for the authorisation of firms and the approval/registration of individuals; avoid unnecessary duplication or underlap across multiple specialised regulators; introduce a consolidated set of rules and guidance; tackle problems of co-ordination, co-operation and communication more effectively within a single entity and under a unified management structure than might be possible across separate specialist entities; offer a single point of contact to both regulated firms and to consumers (through a single complaints handling regime and a single compensation scheme); and adopt a more effective and focused approach to areas of common interest to most regulated financial activities (for example, handling Year 2000 issues and turbulence in international financial markets).[68]

These arguments – consumer protection arrangements that were better suited to the characteristics of new financial instruments, improved oversight of financial conglomerate groups, and cost savings and efficiencies from a common regulatory platform – were at the heart of the

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[67] *See* Taylor, *supra* note 11, at 6.
[68] Briault, *supra* note 14, at 18.

case constructed for the single financial regulator. The difficulty was that exactly these same arguments had been made in favor of an alternative regulatory structure – the so-called Twin Peaks model. It was therefore also necessary for the defenders of the single regulator to explain why this structure would be superior to the Twin Peaks alternative.

IV. THE REJECTION OF THE TWIN PEAKS ALTERNATIVE

Unlike the single regulator, a Twin Peaks structure had been actively debated in the U.K. prior to the 1997 reform, and it had attracted support from a number of influential figures both in the industry and in regulation.[69] It was, however, strongly opposed by the Bank of England which regarded the proposals as primarily an attempt to divest it of its regulatory responsibilities.

Twin Peaks proposed that, instead of being structured around the traditional tripartite distinction of banking, securities and insurance, the institutional structure of regulation should in future comprise two regulatory agencies, a Financial Stability Commission and a Consumer Protection Commission.[70] The first would be responsible for ensuring the stability of the financial system as a whole, mainly through the application of prudential regulations.[71] The second would be charged with ensuring that firms deal with their (retail) customers in a fair and transparent manner.[72] The two Commissions would be responsible for discharging their mandate irrespective of the legal form of the firms that they regulated.[73]

The source of the "blurring the boundaries" argument can be traced to the Twin Peaks proposals, which also placed heavy emphasis on the need to ensure proper group-wide supervision of financial conglomerates.[74]

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[69] *See* Jill Treanor, *Regulators Back Taylor's Twin Peaks Theory*, THE INDEP., Oct. 29, 1996, *available at* http://www.independent.co.uk/news/business/regulators-back-taylors-twinpeaks-theory-1360780.html.

[70] Taylor, *supra* note 11, at 1.

[71] *Id.*

[72] *Id.*

[73] *See id.*

[74] *Id.* at 4. However, the earliest occurrence of this argument is to be found in a working paper published the year before Twin Peaks. *See* Claudio E.V. Borrio & Renata Filosa, *The Changing Borders of Banking: Trends and Implications*, 3, 16 (Bank for Int'l Settlements, Working Paper No. 23, 1994), *available at* http://www.bis.org/publ/ work23.pdf?noframes=1.

The case for Twin Peaks also invoked the economies of scale that would result from (the admittedly more limited) regulatory consolidation that it also involved. Thus, because the arguments for a single regulator and for Twin Peaks were almost identical, it was necessary for the FSA's defenders to show that theirs was the superior solution. The crux of the argument concerned the separation of prudential and conduct of business regulation that was the main feature of the Twin Peaks model; the defenders of a single regulator argued that the separation was not so clear cut as the Twin Peaks model presupposed.[75]

The first strand of this argument was to contest the claim, central to the Twin Peaks analysis, that there were two relatively, clearly distinguishable regulatory objectives – financial stability on the one hand and consumer protection on the other. This case for treating these two objectives as interlinked is well summarized by Davies and Green:

> The ultimate argument for financially sound and prudentially well regulated financial institutions is that they are then able to provide financial services and investment opportunities to consumer and businesses which those customers may use with confidence. A breakdown in consumer protection, whether in banking, investment or insurance products, may itself precipitate a wider loss of confidence in types of product or firms. There is therefore no necessary conflict between the two aims of regulation. In the long run they are aligned.[76]

Closely related to this was the claim further claim that, in practice, prudential and conduct of business (sales practice) regulation required examination of very similar issues, and therefore that there would be significant overlap between the Twin Peaks agencies.[77] Briault put the point with characteristic clarity:

> [T]here is a considerable overlap – both conceptually and in practice – between prudential and conduct of business regulation. Both have a close and

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[75] *See* Briault, *supra* note 14, at 25.

[76] HOWARD DAVIES & DAVID GREEN, GLOBAL FIN. REGULATION: THE ESSENTIAL GUIDE 192 (2008).

[77] Briault, *supra* note 14, at 25.

> legitimate interest in the senior management of any financial institution subject to both of these types of regulation, in particular because of the crucial roles of senior management in setting the "compliance culture" of a firm, in ensuring that management responsibilities are properly allocated and cover comprehensively the business of the firm, and in ensuring that other internal systems and controls are in place. The detail of some of these systems and controls may indeed be specific to either prudential or conduct of business considerations, but many of them will be more general.[78]

In short, a single regulator was superior to a Twin Peaks structure because many of the same supervisory judgments would arise in considering prudential and sales practice regulation. There seemed little point in having two regulators reaching essentially duplicate judgments of broadly similar matters. Since there is substantial overlap between the two regulatory objectives and, in practice, prudential and conduct of business regulation will focus on the same fundamental issues, they were best administered by a single regulatory agency.

The Global Financial Crisis has created a very different perspective on this argument. The British Government's own White Paper on regulatory reform after the crisis has concluded that the system places too much weight on "ensuring that systems and processes were correctly defined rather than on challenging business models and strategies" and on "conduct of business regulation of the banking sector rather than prudential regulation of banking institutions."[79] Even the FSA's senior management has acknowledged that the agency neglected prudential supervision.[80] In the words of the report on the banking crisis produced by the FSA's current chairman, Lord Turner, the agency's regulatory practices resulted in "[a] balance between conduct of business and prudential regulation which, with the benefit of hindsight, now appears biased towards the former."[81] Turner repeated this admission to a committee of the British House of Lords which

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[78] *Id.*

[79] H.M. TREASURY, REFORMING FINANCIAL MARKETS, 2009, Cm. 7667, at 56.

[80] *See* FIN. SERV. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 87 (2009), *available at* http://www.fsa.gov.uk/pubs/ other/ turner_review.pdf.

[81] *Id.*

referred in its final report to the "widely held perception that, in recent years, the FSA has emphasized conduct-of-business supervision at the expense of prudential supervision."[82]

This situation was especially apparent in the FSA's supervision of the mortgage bank Northern Rock which was the first British casualty of the crisis.[83] The bank had received numerous contacts from the FSA concerning a consumer protection initiative ("treating customers fairly"), but supervision of capital and liquidity had been deficient and the bank had been placed in a category that subjected it to one major prudential meeting once every three years. The FSA's own report on Northern Rock stated that "some of the fundamentals of work on assessing risks in firms (notably some of the core elements related to prudential supervision, such as liquidity) have been squeezed out."[84]

The House of Lords Committee thought it could identify the reason why the FSA had failed to give sufficient attention to prudential regulation:

> Conduct-of-business is important and politically sensitive, and its results are easy to measure. In contrast, prudential supervision, while arguably more important, is conducted privately; its success is less easily measured, and, most of the time, it has a lower political impact than conduct-of-business supervision though in times of crisis such as the present its political impact, its effect on businesses, individuals and the economy, is very much greater than conduct-of-business supervision. It is natural and rational for a supervisor with responsibility for both activities to concentrate on the one with the greater immediate political sensitivity.[85]

In other words, the argument that there were synergies between prudential and conduct of business regulation overlooked the distinct possibility that

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[82] SELECT COMMITTEE ON ECONOMIC AFFAIRS, BANKING SUPERVISION AND REGULATION, 2008-09, H.L. 101-I, at 33.

[83] FINANCIAL SERVICES AUTHORITY, THE SUPERVISION OF NORTHERN ROCK: A LESSONS LEARNED REVIEW ¶¶ 8, 27 (2008), *available at* http://www.fsa.gov.uk/ pubs/other/ nr_report.pdf.

[84] *Id.* at ¶ 36.

[85] SELECT COMMITTEE ON ECONOMIC AFFAIRS, BANKING SUPERVISION AND REGULATION, 2008-09, H.L. 101-I, at 33.

one type of regulation would come to dominate within a single regulator and that this would likely to be consumer protection given the realities of the political process.[86] *Twin Peaks* had predicted that this outcome was likely, and used it as one of the arguments against creating a single regulatory agency.[87]

Thus the argument that there was a natural synergy between prudential and consumer protection regulation has been discredited by events both before and during the crisis. If the purported synergies were really as strong as was claimed, then the multiple reviews of Northern Rock's systems for handling consumer issues should have thrown out evidence that the bank's business strategy was dangerously flawed. They did not. Nor is this outcome really surprising. Although there may be some overlap of the relevant judgments at the margin, they ultimately involve quite fundamentally different matters. Weaknesses of internal control systems for dealing with consumer issues may be indicative of more general weaknesses in internal control within the institution as a whole, and this could indeed raise matters of prudential concern. But it is doubtful that these kinds of findings will demonstrate that the bank's management is following a deeply flawed and highly risky business strategy which is likely to end in failure. To reach this conclusion it is necessary to ask different questions to those a consumer protection regulator might ask.

V. THE ROLE OF THE CENTRAL BANK

One dimension of the Twin Peaks structure that had been actively debated before the decision to create the FSA was the role of the central bank. In a number of speeches and articles, the Bank of England's senior management defended the Bank's role as a bank regulator against the proposed Twin Peaks structure.[88] The central bank, it was argued, needed to be concerned with the financial condition of the banking system, as this was the conduit through which its monetary policy was transmitted to the wider economy. As Governor Eddie George argued in a speech given in 1994, before the Twin Peaks debate began, the soundness of banks and the central bank's ability to conduct monetary policy were intimately related:

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[86] *See id.*
[87] Taylor, *supra* note 11, at 15.
[88] Howard Davies, *Financial Regulation: Why, How and By Whom*, *in* BANK OF ENG. Q'LY BULL. 107, 111 (1997).

> Monetary and financial stability are inter-related. It is inconceivable that the monetary authorities could quietly pursue their stability-oriented monetary policy objectives if the financial system through which policy is carried on – and which provides the link with the real economy – were collapsing around their ears. The liabilities of banks in particular are money, and you cannot be concerned with preserving the value of money without being concerned also with preserving public confidence in money in this broader sense. Equally though, the financial system is much less likely to be collapsing around the ears of the monetary authorities in an environment of macro-economic stability than in one of exaggerated boom and bust and volatile asset values. This inter-relationship means that, whatever the precise institutional arrangements for financial regulation and supervision, central banks necessarily have a vital interest in the soundness of the financial system.[89]

Moreover, banks were a "special" type of financial intermediary: as Sir Howard Davies, at that time still the Deputy Governor of the Bank of England,[90] said in early 1997 "in our view, there is still a reasonably clear distinction to be made between banks and other financial institutions, and their prudential soundness, or lack of it, can have rather different implications for the rest of the market." As a result, he continued,

> Of course it may be argued that the distinctive characteristics of banks, and their potential to create systemic risk—which central banks can counteract—does not necessarily mean that the central bank should act as their regulator. I agree. But there are significant synergies to be had from maintaining an institutional link between the two functions, and the burden of proof rests, I think,

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[89] E. A. J. George, Governor, Bank of England, The Bank of England – Objectives and Activities, The Capital Market Research Institute, Frankfurt, Germany (Dec. 5, 1994).

[90] Shortly afterwards he was appointed the first Chairman and Chief Executive of the FSA. His views on the specialness of banks underwent a subsequent change.

> with those who wish to make the case for disturbing that relationship.[91]

The main "synergy" that arose from retaining banking supervision within the central bank was with the Bank's role as lender of last resort (LoLR). It was argued that the information acquired in the capacity of the bank supervisor was essential to the central bank performing the lender of last resort function, and that therefore the best arrangement was for LoLR and banking supervision to be located in the same institution. Following the Northern Rock experience, a number of commentators have reached the conclusion that this argument was correct. As Professor Willem Buiter argued in evidence to the House of Commons Treasury Select Committee:

> The notion that the institution that has the knowledge of the individual banks that may or may not be in trouble would be a different institution from the one that has the money, the resources, to act upon the observation that a particular bank needs lender of last resort support is risky. It is possible, if you are lucky, to manage it, but it is an invitation to disaster, to delay, and to wrong decisions. The key implication of that is that the same institution—it could be the FSA or it could be the Bank of England—should have both the individual, specific information and the money to do something about it.[92]

Against these arguments, proponents of separation argued that theoretical considerations and empirical evidence indicated that central banks with banking supervisory responsibilities tended to err on the side of laxity in monetary policy; as Goodhart and Schoenmaker argued in a widely cited paper, monetary policy aimed to be countercyclical, whereas regulatory policy was pro-cyclical.[93] Concerns were also expressed that banking supervision "failures" – which it was generally accepted were

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[91] DAVIES, *supra* note 88, at 110.

[92] *Id.*

[93] C. A. E. Goodhart & D. Schoenmaker, *The Institutional Separation Between Supervisory and Monetary Agencies*, *in* THE CENTRAL BANK AND THE FINANCIAL SYSTEM 341 (1995)..

almost inevitable – would damage the reputation and credibility of the central bank as a monetary policy institution.[94]

Twin Peaks further argued that "[a]s the once-clear demarcation lines between types of financial markets and institutions are broken down, the Bank's role appears increasingly anomalous."[95] In other words, owing to the changing nature of the financial system, banks could no longer be considered the unique source of systemic risk that traditionalists insisted that they remain. In consequence of these developments, it became increasingly difficult to argue that banks were "special" in the sense that they were uniquely, systemically important.[96] Many large non-banks were now "too interconnected to fail," a phrase that was coined when Bear Stearns teetered on the brink of failure in March 2008.[97] On the traditional view, Bear Stearns would not have been considered systemically important; however, the episode confirmed the argument of *Twin Peaks* that "the rise of the OTC markets means that we must extend our concept of what constitutes a systemically important firm."[98]

Yet if the concept of a systemically important firm was extended in this way, it was by no means obvious that the central bank was the right institution to regulate these firms. Twin Peaks acknowledged the possibility that the functions of the FSC could be performed by the central bank and that LoLR was an important issue.[99] However, on balance it rejected the case for the central bank also performing the role of prudential regulator of the new, broader category of systemically important firms.[100] In the first place, a broader concept of systemically important firms meant that the central bank would need to interact with various institutions that were not its traditional counterparties (a prediction that has come to pass following the Federal Reserve's expansion of its facilities in the wake of the financial crisis).[101] Secondly, the expertise necessary to regulate investment banks and insurance companies does not naturally reside in central banks.[102] As *Twin Peaks* identified, a major problem for central banks is in finding a place for such regulatory specialists in organizations

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[94] *Id.* at 341

[95] Taylor, *supra* note 11, at 13-14.

[96] *Id.* at 4.

[97] *Id.*

[98] *Id.* at 5.

[99] *Id.* at 14.

[100] *Id.* at 13-14.

[101] Taylor, *supra* note 11, at 5.

[102] *Id.* at 6, 12.

where they will have few opportunities for career progression.[103] Nonetheless, Twin Peaks also recognized that close links would be needed between the central bank and the FSC.[104] Although it was comparatively sketchy about the nature of those links, apart from proposing overlapping board membership, the need for close coordination between the central bank and the prudential regulator was an important component of the Twin Peaks structure.[105]

The FSA's relationship with the Bank of England was, in theory, also to be a close one.[106] Yet when the FSA was established, very little attention was given to the need for institutional linkages between the regulator and the central bank.[107] Instead, given the prominent role played by ex-Bank of England staff in the FSA, the professional relationships between former colleagues were supposed to guarantee cooperation between the two institutions. However, once this generation of officials had either retired or left the FSA, there was no institutional mechanism to ensure close collaboration between the two institutions. More recently, the British government has announced the formation of a Financial Stability Council which can be seen as a belated attempt to build the stronger institutional linkages between the Bank and the FSA that were required from the outset.

Briault acknowledged that in the "multi-faceted" relationship between Bank and FSA, close cooperation and regular information flows would be essential. These would need to occur both routinely for those aspects of financial stability in which the central bank has an interest for the setting of monetary policy, and in exceptional circumstances for more specific and detailed information relating to the position of financial institutions for whom support operations are being considered (where the fiscal authority is also likely to have a close interest). "The UK Memorandum of Understanding… provides an important underpinning to the necessary exchange of such information under the new arrangements in the UK."[108]

The Memorandum of Understanding to which Briault refers was between the Treasury, Bank of England, and FSA and it supposedly created

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[103] *Id.* at 12.
[104] *Id.* at 14.
[105] *Id.*
[106] *Id.* at 13-14.
[107] Taylor, *supra* note 11, at 13.
[108] Briault, *supra* note 14, at 33.

the framework for both information exchange and for crisis management.[109] These are referred to under the MoU as the "Tripartite Authorities" and the Bank of England's responsibilities are summarised as contributing "to the maintenance of the stability of the financial system as a whole."[110] The FSA has the responsibility of authorising and supervising individual banks.[111] HM Treasury has responsibility for the institutional structure of the financial regulatory system, and the legislation behind it.[112] In a crisis, the Financial Services Authority would, according to the Memorandum of Understanding, be responsible for monitoring "the health of institutions that fall within its regulatory remit" and for ensuring, "as far as is appropriate in the circumstances, continuing compliance with regulatory standards."[113] However, the Bank of England would remain in charge of "official financial operations … in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system".[114]

The MoU also established a Joint Crisis Management Committee, chaired by the Chancellor, for dealing with what the MoU referred to generically as "support operations."[115] It did not, however, clearly distinguish between those operations that relate to emergency liquidity assistance and those that would involve solvency support.[116] In both cases the Treasury sat at the apex of a pyramid with both the Bank and FSA in subordinate roles.[117] This contrasts with the practice of most other countries in crisis management, which is to ensure that as long as the issue remains one of liquidity the central bank will be in the lead.[118] It alone has (or should have) the information and the ability to react sufficiently

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109 GORDON BROWN ET AL., MEMORANDUM OF UNDERSTANDING BETWEEN H.M. TREASURY, THE BANK OF ENGLAND AND THE FINANCIAL SERVICES AUTHORITY 4-5 (2009), *available at* http://www.bankofengland.co.uk/financialstability/mou.pdf [hereinafter MoU].

110 *Id.* ¶ 2.

111 *Id.* ¶ 3(i).

112 *Id.* ¶ 4(i).

113 *Id.* ¶ 17(iii).

114 *Id.* ¶ 2(iv).

115 GORDON BROWN ET AL., *supra* note 109, at ¶ 14.

116 *Id.* ¶ 17(iii).

117 *Id.* at ¶ 4, 10, 13.

118 Dong He, "Emergency Liquidity Support Facilities", Appendix in CHARLES ENOCH et al (eds) BUILDING STRONG BANKS THROUGH SURVEILLANCE AND RESOLUTION (IMF 2002), p.134

promptly to emerging problems.[119] In this case the FSA's role would be clearly established as that of a handmaiden to the Bank, under an explicit obligation to provide it with any and all information required by for the discharge of its duties.[120] Only in the event that the issue becomes one of providing solvency support should the Treasury have taken the lead, with both the Bank and the FSA in supporting roles.[121] The subordinate role to which the Bank was assigned in the MoU provides support to those who argue that the post-1997 arrangements were designed to reduce the Bank's status.

In practice, however, the arrangements envisaged by the MoU were rarely tried in practice and the Joint Crisis Management Committee rarely met. The House of Commons Treasury Select Committee, in reviewing the Northern Rock experience, concluded that "in terms of information exchange between the Tripartite authorities, the system might have ensured that all the Tripartite authorities were fully informed. However, for a run on a bank to have occurred in the United Kingdom is unacceptable, and represents a significant failure of the Tripartite system."[122]

VI. LESSONS OF THE BRITISH EXPERIENCE FOR UNITED STATES REGULATORY REFORM

Reviewing the lessons of the British experience, and considering the current regulatory reform debate in the United States, I offer the following conclusions:

A. THE CONCEPT OF A SINGLE REGULATOR HAS NOT BEEN DISCREDITED, BUT ITS LIMITATIONS HAVE BEEN EXPOSED

The U.K. was not the first country to establish a unified regulatory agency outside the central bank: that honor belongs to the Scandinavian countries, with Norway (1986) as the pioneer followed by Denmark (1988) and Sweden (1991).[123] In these countries an important consideration was

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[119] *Id.* at ¶ 2, 4.
[120] *Id.* at ¶ 6.
[121] GORDON BROWN ET AL., *supra* note 109, at ¶ 14.
[122] HOUSE OF COMMONS TREASURY COMMITTEE, THE RUN ON THE ROCK, 2007-08, H.C. 56-1, at 107.
[123] Taylor & Fleming, *supra* note 16, at 6-7.

the "economies of scale" argument.[124] As relatively small countries with financial systems dominated by a small number of financial conglomerate groups, combining all regulatory functions within a single agency appeared to offer numerous efficiency benefits.[125] Moreover, since the central bank was not involved in banking supervision in any of these countries, the powerful – and sometimes emotive – issue of the central bank's powers did not arise.[126]

There continues to be a case for single regulatory agencies in comparatively small countries where the economies of scale gains are significant.[127] It is expensive to establish regulatory agencies with their associated support services and infrastructure, and therefore minimizing overhead costs is a worthwhile ambition. However, in larger countries, especially those with a large and complex financial system, any potential efficiency gains are far outweighed by the inefficiencies of combining too many regulatory functions in a single agency. As noted above, the FSA has struggled with the combination of prudential and conduct of business regulation and its past performance suggests that it was simply tasked with too many functions to perform all of them adequately.

B. PRUDENTIAL AND CONDUCT OF BUSINESS REGULATION DON'T MIX

Despite the claims of the FSA's supporters that there are substantial synergies between prudential and conduct of business regulation, the crisis has shown the limits of these synergies. While some of the relevant supervisory judgements do overlap, especially on such matters as internal controls and the probity of management, prudential regulation needs a different focus. The factors influencing the financial soundness of an institution and the likelihood that it might fail go far beyond those of concern to a consumer protection regulator. Moreover, as the House of Lords Select Committee on Economic Affairs observed,

> There is also a cultural difference between conduct-of-business and prudential supervision. Conduct-of business supervision is often performed by lawyers. Prudential

[124] *Id.* at 25.
[125] *See id.*
[126] *Id.* at 17.
[127] *Id.* at 31.

> supervision is largely an economic activity, particularly at the macro level. It seems likely that either a lawyerly or an economic approach would dominate in a supervisory body that performed both prudential and conduct of business supervision, and that this dominance would reduce the effectiveness of the dominated half of the organisation.[128]

The function that receives the greatest emphasis will be that having the greatest political saliency: this means that in normal times, when bank failures are rare, consumer protection regulation is likely to be the main focus of agency attention. Although the FSA has now increased the resources it devotes to prudential regulation,[129] the above analysis suggests that this is likely to be a relatively short term development, remaining in place only as long as political attention is focused on the fall-out from the crisis.

C. IT IS ESSENTIAL TO ACHIEVE A BALANCE BETWEEN THE FINANCIAL STABILITY AND CONSUMER PROTECTION OBJECTIVES

Because of the circumstances in which the U.K.'s regulatory reforms took place – as a reaction to perceived regulatory failures in consumer protection – it was perhaps inevitable that this aspect of regulation should have been their main focus. The overarching desire on the part of the FSA's architects was to establish a strong consumer protection regulator that would be independent of the industry.[130] However, one consequence of the consumer protection focus was that the financial stability objective did not receive the attention that it either warranted or deserved.[131] Fortunately, the Northern Rock episode has provided the impetus to restore some balance to the post-1997 arrangements. The Bank of England has now been given both formal statutory responsibility for financial stability and for handling bank resolutions under a new legislative framework, the Banking Act 2009.[132]

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[128] SELECT COMMITTEE ON ECONOMIC AFFAIRS, BANKING SUPERVISION AND REGULATION, 2008-09, H.L. 101-I, at 33.

[129] *Id.* at 32.

[130] *Id.* at 30, 32, 52-53.

[131] *Id.* at 31-32.

[132] *Id.* at 30-31.

However, as noted earlier, there are still a number of aspects of the "Tripartite system" where reforms are still needed. In addition, although charged with the formal statutory responsibility for maintaining financial stability the Bank of England lacks most of the policy tools it needs for this task. Hence, even now, the rebalancing is only partly finished.

A second dimension of the financial stability focus concerns what is now termed "macroprudential" regulation. When the U.K.'s arrangements were put in place, prudential regulation was conceptualized in terms of ensuring the soundness of individual institutions. As the financial crisis has made clear, however, ensuring the soundness of individual firms is a necessary, but not sufficient condition for ensuring financial stability. While in one respect the comparative neglect of financial stability issues under the U.K.'s post-1997 arrangements was due to an oversight, it also reflected the fact that what is now called the macro-prudential perspective had not at the time gained the prominence that it now enjoys. As noted above, an unfinished aspect of the U.K's attempt to re-balance its regulatory system concerns the additional macroprudential powers that should be assigned to the Bank of England.

D. POLITICALLY MOTIVATED REFORMS OR THOSE MOTIVATED BY A DESIRE TO "PUNISH" THE CENTRAL BANK ARE COUNTERPRODUCTIVE

There is at least some circumstantial evidence for concluding that part of the motivation for the U.K.'s reforms was to "punish" the central bank or to "cut it down to size."[133] However, as the subsequent British experience shows, there is no plausible alternative to having a central bank with an extensive mandate and the ability to intervene to mitigate a crisis. The FSA's architects appear to have believed that it would be possible to create a rival center of power to the Bank, without realizing the reality that without significant financial muscle of its own, the FSA was destined to play a subsidiary role in any crisis. Only the central bank has the ability to play the role of LoLR and this fact means that it must play a unique role in any financial safety net arrangement. The members of the U.S. Congress who have recently criticized the Federal Reserve for its actions in stemming the crisis need to reflect on whether there are any viable alternatives. The British experience suggests that there are not.

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[133] Jacomb, *supra* note 49, at 3-4.

E. SOME "OVERLAP" AND "DUPLICATION" OF REGULATORY FUNCTIONS IS UNAVOIDABLE

As should now be apparent, the U.K.'s regulatory reforms were inspired, to a very large extent, by the desire to eliminate the perceived duplication and overlap of regulatory authority resulting from the Financial Services Act system in particular. While the Act had indeed created a system that was excessively complex – especially from the point of view of the individual consumer – this factor arguably received too much attention in the resulting reforms.

A particularly clear example was the decision not to give the Bank of England its own powers to gather information from the financial sector (banks in particular). It was therefore reliant on the FSA to provide it with the data it required to perform its "financial stability" function.[134] The thinking appeared to be that if the FSA was to be the banking supervisor, the Bank of England should have only a general role in relation to overall financial stability, and did not require the ability to gather institution-specific information. [135] Because one stated objective of the 1997 reforms was to reduce regulatory duplication and overlap – a major selling point with the industry – only the FSA was given information-gathering powers.

This decision ignored the experience of many other countries where the central bank was not itself the prudential regulator, and indeed the Bank of England's own history before it assumed the statutory responsibility for bank regulation in 1979.[136] In its role as lender of last resort it had been able to exert significant moral suasion over the banking sector, and the Discount Office was able to obtain information from banks on a purely informal basis.[137] Other central banks also enjoy substantial information gathering powers of their own.[138] For example, the Bank of Japan's information-gathering ability includes the power to conduct bank examinations, notwithstanding that this duplicates the function of the Financial Services Agency. These precedents should have shown that even without the formal statutory responsibility for banking supervision, the

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134 BROWN, *supra* note 109, at ¶ 8.

135 *Id.* at ¶ 6.

136 *See Schooner* & Taylor, *supra* note 2, at 629-32.

137 *Id.* at 614-15.

138 INSTITUTE FOR MONETARY AND ECONOMIC STUDIES, FUNCTIONS AND OPERATIONS OF THE BANK OF JAPAN 80 (2004), available at www.boj.or.jp/en/type/exp/about/data/ foboj01.pdf

central bank still needed to have access to substantial amounts of institution-specific information and ideally its own capacity to go about gathering that information.

F. CRISIS MANAGEMENT PREPAREDNESS MATTERS

Finally, insufficient attention was given to crisis management arrangements. For at least two decades prior to the formation of the FSA, the U.K. had not experienced any episodes of serious financial distress. This may have bred a certain degree of complacency about the need for adequacy crisis management preparedness and planning. Although the Memorandum of Understanding was drawn up between the Treasury, Bank of England, and FSA, the arrangements envisaged were rarely tried in practice and the Joint Crisis Management Committee rarely met. The arrangements also assumed that the Treasury would be the glue that held this system together, thus involving it in the minutiae of crisis management decision-making – a role that it was ill-equipped to perform and one that hampered the ability to reach quick decisions in an environment where time was of the essence.[139] It is therefore necessary to ensure that the central bank's freedom of manoeuvre is not excessively constrained by any arrangements that are put in place.

VII. CONCLUSION: THE RETURN TO "TWIN PEAKS"

In the aftermath of the Global Financial Crisis there has been a revival of interest in the Twin Peaks model. The experience of the U.K. during the financial crisis has strengthened the arguments of the FSA's critics who challenged the viability of a single regulatory agency in a financial centre as large and diverse as the U.K. The British Conservative party, which at the time of writing is still in opposition but is expected to win the election due in 2010, has now adopted the policy of abolishing the FSA and introducing a division between prudential and conduct of business regulation with the former being returned to the Bank of England.[140] Similarly, in the U.S., the Twin Peaks concept has received attention in

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[139] Peter Hayward "The Financial Sector – The Responsibilities of Public Agencies" in CHARLES ENOCH et al, supra note 118.

[140] George Osborne, *Foreword*, *in* FROM CRISIS TO CONFIDENCE: PLAN FOR SOUND BANKING (2009).

evidence given to Congressional committees[141] and as a major source of the Bush administration's proposals of 2008.

As can be seen from the above analysis, when Britain adopted its single regulator structure in 1997, it did not do so due to a conscious rejection of the Twin Peaks alternative. Rather, the British government's decision seems to have owed more to the legislative timetable and the apparent simplicity of the single regulator in avoiding some of the complexity, duplication and opacity which had been a focus of the criticisms of the previous system. The single regulator's very simplicity may well have been a factor in its favour; but the apparent simplicity of the structure was deceptive as it resulted in some of the complexities of financial regulation and crisis management being neglected.

The Twin Peaks alternative might, arguably, have avoided some of the design flaws of the post-1997 arrangements. In particular, it would have avoided trying to set up a rival center of power to the Bank of England, thereby creating crisis management arrangements that were far too unwieldy. Because the Bank and the FSA were assigned equal status in the Tripartite arrangements, the active role of the Treasury was essential to hold the ring and to ensure a cooperative relationship between the two agencies. By contrast, a specialist prudential regulator might have been established more clearly under the Bank of England's wing, and as a result could have enjoyed much closer links with the central bank than did the FSA. There are a variety of precedents for this possible arrangement: the relationship between the Bank of France and the Commission Bancaire, or between the Finnish Central Bank and that country's Financial Supervision Agency could have been potential models.[142] In these structures, although the regulatory agencies are governed by boards separate from those of the central bank, their staff are central bank employees and extensive use is made of shared facilities, information technology platforms and databases.

Nonetheless, although Twin Peaks has its attractions, it is necessary to be cautious about trying to introduce too much neatness and tidiness into regulatory structures. The objectives of financial regulation can be neatly packaged into two, but the range of regulatory functions is far more diverse. At least six (or possibly seven) regulatory functions can be

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[141] *See Enhancing Investor Protection and the Regulation Of Securities Markets: Hearing Before S. Comm. on Banking, Housing and Urban Affairs*, 11th Cong. 36-39 (2009) (testimony of Mr. John Coffee, Professor, Columbia Law School).

[142] *See* Abrams & Taylor, *supra* note 9, at 23-24.

identified: financial system stability; crisis management; the prudential regulation of systemically important firms; the prudential regulation of firms that are not systemically important; sales practice regulation; and market conduct regulation.[143] (Competition policy is a possible seventh regulatory function although it applies in many sectors other than financial services.) At its most basic, the problem of designing a regulatory structure is one of deciding which of these functions belong together in the same agency. The single regulator concept tried to combine most of these functions within one agency. That has been shown to be a step too far. But there are many possible configurations between this option and the current highly fragemented regulatory system in the United States.

[143] *See* C. A. E. GOODHART ET AL., FINANCIAL REGULATION: HOW, WHO AND WHERE NOW? (1998).